NEWCASTLE MUNICIPALITY

BORROWING POLICY

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1. PREAMBLE

1.1 Considering the large demand for municipal infrastructure, borrowing is an important element to obtain additional funding sources to fund the municipal capital programme over the medium term.

1.2 Given that a large portion of municipal infrastructure has a long-term economic life and a general principle is that the current ratepayers should not pay for the usage of future ratepayers, there is a strong economic argument to finance this capital expenditure through long-term borrowing in order to accelerate the pace of delivery and to mirror the repayment of funds with the economic life of the asset.

2. DEFINITIONS

"***Act***" means the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003).

"current year" means the financial year which has already commenced but not yet ended;

"debt" means-

(a) monetary liability or obligation created by a financing agreement, note, *55* debenture, bond or overdraft, or by the issuance of municipal debt instruments: or

(b) a contingent liability such as that created by guaranteeing a monetary liability or obligation of another;

"***disclosure statements***" means a statement issued or to be issued by:

- a municipality which intends to incur debt by issuing municipal debt instruments; and
- a person who intends to incur debt by issuing securities backed by municipal debt.

"***financing agreement***" means any loan agreement, lease, instalment, purchase arrangement under which a municipality undertakes to repay a long-term debt over a period of time.

"***lender***" in relation to a municipality means a person who provides debt finance to the municipality.

"***long term debt***" means debt repayable by the municipality over a period exceeding one (1) year.

"***municipal debt***" means:

(c) a monetary liability or obligation on a municipality by:

  - a financing agreement, note, debenture, bond or overdraft; and
  - the issuance of municipal debt instruments.

(d) a contingent liability such as that created by guaranteeing a monetary liability or obligation of another.

"***security***" means any mechanism intended to secure the interest of a lender or investor and includes any of the mechanisms mentioned.

"***short term debt***" means debt that is repayable over a period not exceeding one (1) year.

3. POLICY OBJECTIVES

The objectives of the policy are to:

3.1 enable the municipality to exercise its obligation to ensure sufficient cash resources to implement capital programme in the most cost effective manner;

3.2 ensure compliance with the relevant legal and statutory requirements relating to municipal borrowing;

3.3 govern the taking up of short-term and long-term debt according to the legislative framework;

3.4 manage interest rate and credit risk exposure;

3.5 maintain debt with specified limits and ensure adequate provision for the repayment of debt; and

3.6 maintain financial sustainability.

4. SCOPE OF THE POLICY

4.1 This policy shall apply to the Council, Executive Committee, all Portfolio Committees, Accounting Officer and Strategic Executive Directors. It is, however, specifically applicable to the council and all officials who have a formal, administrative duty to deal with capital projects and programmes of the municipality management of budget.

5. APPLICABLE LEGISLATION

5.1 In terms of the Municipal Finance Management Act, No. 56 of 2003, Chapter 6 on Debt, Section 45 (1) which deals with short-term debts states that a municipality may incur short-term debt only in accordance with and subject to the provisions of the act and only when necessary to bridge shortfalls and capital needs within a specific financial year.

5.2 In terms of the Municipal Finance Management Act, No. 56 of 2003, Chapter 6 on Debt, Section 46 (1) which deals with long-term debts states that a municipality may incur short-term debt only in accordance with and subject any applicable provisions of the act, including Section 19 for the purposes of capital expenditure or re-financing existing long-term debt.

5.3 Local Government Municipal Regulations and Debt Disclosure, Regulation R492, published under Government Gazette 29966, 15 June 2007 further regulates compulsory disclosures when incurring municipal debt and securities backed by municipal debt.

6. BORROWING PRINCIPLES

6.1 The economic life of assets should always be equal to or longer than the tenure of the debt finance.

There are five main reasons why access to financial markets is considered important for local authorities. These may be summarised as follows:

- *Access to capital*. Local governments in SA are responsible for infrastructure that requires large, “lumpy” capital investments on a periodic basis. Given the extensive needs in SA, financing this investment on a “pay-as-you-go” or “taxation-in-advance” basis is usually neither possible nor efficient. Particularly where the need for capital greatly exceeds what is available on a grant basis from the central fiscus, access to capital markets can provide municipalities with the capital resources necessary to finance infrastructure investments efficiently.

- *Inter-temporal equity.* The benefits of the infrastructure investments that municipalities make often endure for extensive periods and accrue to future generations of taxpayers and consumers. It is equitable for such generations to bear some of the costs of these benefits. Financing investment over time with funds accessed from capital markets allows for this.

- *Efficiency*. Because capital markets allocate capital resources on a commercial basis, capital should be appropriated efficiently. Moreover, the opportunity costs of capital provide incentives to ensure efficient standards of delivery and discouraged “overbuilding” and wasteful investment.

- *Accountability.* Markets tend to punish poor fiscal and management performance through pricing (pushing up interest rates or making capital increasingly scarce.) This can promote accountability and fiscal discipline at the local level. It may also provide other stakeholders (national government; the provinces; aid agencies and so on) with a convenient means to assess the relative performance of municipal governments.

- *Short-term matching of revenues and expenditures.* In the short term – for example within a given financial year – municipal revenues and expenditures are seldom completely congruent in time. Short-term borrowing allows municipalities to deal with this lack of synchronicity.

- International experience suggests that achieving these benefits depends on the method of access and the conditions under which this access occurs. In principle there are two main routes here: local governments can access capital markets through "on-lending" from central government, most often through a *Policy Framework for Municipal Borrowing and Financial Emergencies* 9 public intermediary (a financial parastatal), or they may access the markets directly.

In SA the DBSA, which is increasingly active in the municipal market, already represents one "indirect" access mechanism. As already recorded, the interface between this mechanism and the private market in respect of municipal debt is an important issue which will require further attention once the policy framework outlined below is established in legislation. The DBSA aside, there are three broad reasons that government wishes to facilitate direct access by municipalities to the capital markets:

- *Limitation of implicit or contingent liabilities*. It is important to protect central government from ultimately inheriting the debts of local government. When sub-sovereigns borrow through central government the debts of these bodies easily become the implicit or contingent liabilities of central government. Policy and legislation need to ensure that central government is not perceived as banker of last resort. This is necessary for prudent fiscal management at the national level and is fundamental to government's ability to maintain its macro targets. It is also needed to ensure that municipalities face strong incentives to improve their own management and creditworthiness, knowing that it is unlikely that central support will be forthcoming to compensate for local mismanagement or policy errors.

- *Systemic discipline*. International experience suggests that the indirect borrowing route can result in situations where credit allocation decisions become increasingly less commercial in character. Under such conditions, capital does not necessarily flow to the most productive uses, but to those players which are politically the most astute. In other words the efficiency and accountability outcomes mentioned above become diluted. Incentives for inefficient and wasteful decision-making can replace those which encourage the productive use of capital and tight financial management.

- *Expanding investment resources*. Subsovereign borrowing via the state can result in the "squeezing out" of private capital from the municipal sector, thereby narrowing the aggregate resource available for investment. Moreover, central control of borrowing can also create incentives for local governments to elude these restrictions through innovative off-budget schemes. Centralised borrowing, therefore, does not necessarily increase the ability of central government to control the liabilities of local government, but it may simultaneously diminish the overall financial resource base for investment in worthy projects.

In sum, direct access to capital markets offers the potential for a more transparent, market-based system to develop where there is a greater chance of achieving the benefits of accessing capital markets discussed above. However, it is also true that moral hazard problems – which arise from the assumption by capital markets that borrowing by local governments is ultimately backed by central government - may also develop where there is direct borrowing by sub sovereigns from private financial markets. Ultimately, such problems can never be eliminated completely. The basic objective of the detailed policy framework given below is to ensure that such risks are managed through an appropriate regulatory framework while allowing market discipline to guide the allocation of capital in order to maximise the potential benefits that this offers.

7. COMPULSORY DISCLOSURES WHEN INCURRING MUNICIPAL DEBT

7.1 When entering into discussions with a prospective lender with a view to incur municipal debt, the municipality must indicate in writing to the prospective lender whether it intends to incur short-term or long-term debt.

7.2 In the case of short-term debt it must be disclosed whether the debt is to bridge:

(a) shortfalls within a financial year during which the debt is incurred, in expectation or specific and realistic anticipated revenue to be received with that financial year; or

(b) capital needs within a financial year, to be repaid from specific funds to be received from enforceable allocation or long-term debt commitments.

7.3 In the case of long-term debt, whether the purposes of the debt is for:

(a) capital expenditure on property, plant or equipment to be used for the purpose of achieving the objectives of local government, subject to section 46(4) of the Act.

(b) refinancing of existing long-term debt, subject to section 46(5) of the Act.

8. BORROWING PROCESS

The process as required by the Act is as follows:

8.1 <u>Short-term debt</u>

8.1.1 Newcastle Municipality may incur short-term debt only if:

(a) a resolution of the municipal council, signed by the mayor, has approved the debt agreement; and

(b) the accounting officer has signed the agreement or other document which creates or acknowledges the debt.

8.1.2 A short term debt transaction may be:

(c) Approve by the municipality alone; or

(d) approve an agreement with a lender for short-term credit facility to be accessed as and when required, including a line of credit or bank overdraft facility, provided that:

(i) the credit limit must be specified in the resolution of the council;

(ii) in terms of the agreement, including the credit limit, may be changed only by a resolution of the council; and

(iii) if the council approves a credit facility that is limited to emergency use, the accounting officer must notify the council in writing as soon as practical of the amount, duration and cost of any debt incurred in terms of such a credit facility, as well as options for repaying such debt.

8.1.3 Newcastle Municipality:

(a) must pay off short-term debt within the financial year; and

(b) may not renew or refinance short-term debt, whether its own debt or that of any other entity, where such renewal or refinancing will have the effect of extending the short-term debt into a new financial year.

8.1.4 No lender may willfully extend credit to a municipality for the purpose of renewing or refinancing short-term debt that must be paid off in terms of subsection 6.3 (a).

8.1.5 If a lender willfully extends credit to a municipality in contravention of paragraph 6.4, the municipality is not bound to repay the loan or interest on the loan.

8.1.6 Subsection 6.1.5 does not apply if the lender:

(a) relied in good faith on written representations of the municipality as to the purpose of the borrowing; and

(b) did not know and had no reason to believe that the borrowing was for the purpose of renewing or refinancing short-term debt.

8.2 <u>Long-term debt</u>

8.2.1 Newcastle Municipality may incur long-term debt only if:

(a) a resolution of the municipal council, signed by the mayor, has approved the debt agreement; and

(b) the accounting officer has signed the agreement or other document which creates or acknowledges the debt.

8.2.2 Newcastle Municipality may incur long-term debt only if the accounting officer of the municipality:

(a) has, in accordance with section 21A of the Municipal Systems Act:

(i) at least twenty one (21) days prior to the meeting the council at which approval for the debt is to be considered, made public an information statement setting out particulars of the proposed debt, including the amount of the proposed debt, the purposes for which the debt is to be incurred and particulars of any security to be provided; and

(i) invited the public, the National Treasury and the relevant provincial treasury to submit written comments or representations to the council in respect of the proposed debt; and

(b) has submitted a copy of the information statement to the municipal council at least twenty one (21) days prior to the meeting of the council, together with particulars of:

(i) the essential repayment terms, including the anticipated debt repayment schedule; and

(i) the anticipated total cost in connection with such debt over the repayment period.

8.2.3 Capital expenditure contemplated in 5.3(a) may include:

(a) financing costs, including:

(ii) costs associated with security arrangements in accordance with section 48 of the Act;

(iii) discounts and fees in connection with the financing;

(iv) fees for legal, financial, advisory, trustee, credit rating and other services directly connected to the financing; and

(v) costs connected to the sale or placement of debt, and costs for printing and publication directly connected to the financing.

(b) costs of professional services directly related to the capital expenditure; and

(c) such other costs as may be prescribed.

8.2.4 A municipality may borrow money for the purpose of refinancing existing long-term debt, provided that:

(a) the existing long-term debt was lawfully incurred;

(b) the refinancing does not extend the term of the debt beyond the useful life of the property, plant or equipment for which the money was originally borrowed;

(c) the net present value of projected future payments (including principal and interest payments) after refinancing is less than the net present value of projected future payments before refinancing; and

(d) the discount rate used in projecting net present value referred to in paragraph (c), and any assumptions in connection with the calculations, must be reasonable and in accordance with criteria set out in a framework that may be prescribed.

8.2.5 A municipality's long-term debt must be consistent with its capital budget referred to in section 17(2) of the Act.

9. CONDITIONS APPLYING TO BOTH SHORT-TERM AND LONG-TERM DEBT

9.1 Newcastle Municipality may incur debt only if:

(a) the debt is denominated in rand and is not indexed to, or affected by fluctuations in the value of the rand against any foreign currency; and

(b) section 48(3) of the Act has been complied with, if security is to be provided by the municipality.

10. SECURITIES

10.1 Newcastle Municipality may by resolution of its council provide security for:

(a) any of its debt obligations; and

(b) contractual obligations of the municipality undertaken in connection with capital expenditure by the persons on property, plant or equipment to be used by the municipality or such other person for the purpose of achieving the objectives of local government in terms of section 152 of the Constitution.

10.2 Appropriate security is contemplated in section 48(2) of the Act.

10.3 Other additional conditions to be complied with are contemplated in section 48(3) to (5) of the Act.

11. DISCLOSURE

11.1 Any person involved in the borrowing of money by a municipality must, when interacting with a prospective lender or when preparing documentation for consideration by a prospective investor:

(a) disclose all information in that person's possession or within that person's knowledge that may be material to the decision of that prospective lender or investor; and

(b) take reasonable care to ensure the accuracy of any information disclosed.

11.2 Lender or investor may rely on written representations of the municipality signed by the accounting officer, if the lender or investor did not know and had no reason to believe that those representations were false or misleading.

12. GUARANTEES

12.1 Newcastle Municipality may not issue any guarantee for any commitment or debt of any organ of state or person, except on the following condition:

(a) the guarantee must be within limits specified in the municipality's approved budget.

12.2 Neither the national nor a provincial government may guarantee the debt of a municipality except to the extent that chapter 8 of the Public Finance Management Act provides for such guarantees.

13. SUBMISSION OF DOCUMENTS

13.1 When entering into discussion with a prospective lender with a view to incur short-term or long-term debt, the following information must be made available to the prospective lender.

(a) audited financial statements for the preceding three (3) financial years with audited outcomes;

(b) approved annual budget;

(c) the municipal integrated development plan;

(d) repayment schedules pertaining to existing short-term or long-term debt.

14. NOTIFICATION TO NATIONAL TREASURY

All information prescribed in the act must be provided to National Treasury with respect to a long-term debt proposal. Any intention to incur a long term debt must also be reported to National and Provincial Treasury for the purpose of affordability assessment.

15. FINANCIAL AFFAIRS OF THE MUNICIPALITY

The following information concerning the financial situation and financial management of the municipality must be disclosed:

(a) schedule of all long-term debt obligations stating principal and interest payments for the life of all loans and any security provided to secure such debt;

(b) the amount of any short-term debt outstanding;

(c) the revenue of the municipality for the preceding three (3) financial years stated separately:
   (i) government grants and public donations;
   (ii) revenue from rates and service charges; and
   (iii) other revenue sources
(d) what source of funding will be used to repay the loan;
(e) details of any default by the municipality on outstanding or repaid debt during the preceding three (3) years;
(f) the reserves of the municipality;
(g) a summary of financial policies and practices; and
(h) the latest credit rating obtained.

16. INTEREST RATE RISK

16.1 As a general principle when interest rates are expected to decrease, it is advisable that a floating rate be negotiated in order to take advantage of the lower interest rates in future. If interest rates are expected to increase, it is advisable to obtain a fixed rate so that the benefits of the current low interest rate are maintained.

16.2 The interest risk must be limited in so far as possible. The policy directive is to negotiate fixed interest rates for all long-term borrowings. This will ensure stability of the repayments and reduce the risk for high rates and tariff increases as a result of interest rate hikes in the market.

16.3 Variable rates should be considered for short-term debt only.

17. LIMITATIONS

To ensure a financial viable municipality the following ratios are used to determine the municipal gearing ability to borrow:

- long-term credit rating of BBB;
- interest cost to total expenditure to not exceed 8%;
- long-term debt to revenue (excluding grants) not be exceed 50%;
- payment rate mature above 95%; and
- percentage of capital charges to operating expenditure less than 18%.

18. IMPLEMENTATION AND REVIEW OF THIS POLICY

18.1 The Accounting Officer shall be responsible for the implementation and administration of this policy with the assistance of the Strategic Executive Director for Financial Services Department once approved by Council. All future borrowings must be considered in accordance with this policy read with MFMA and Local Government Municipal Regulations and Debt Disclosure, Regulation R492, published under Government Gazette 29966, 15 June 2007 and other directives and guidelines issued by National Treasury.

18.2 In terms of section 17(1) (e) of the Municipal Finance Management Act, 2003 this policy shall be reviewed on annual basis to ensure that it complies with changes in applicable legislation and regulation and the reviewed policy tabled to Council for approval as part of the budget process .

18.3 This policy must be read together with the Budget and Funding and Reserves Policies; Local Government Municipal Finance Management Act, Act 56 of 2003; and Local Government Municipal Budget and Reporting Regulation, Regulation 393, published under Government Gazette 32141, 17 April 2009.